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SUBJECT: WORLD BANK'S IFC ON ASSET BUBBLES, HOUSING COSTS, ECONOMIC
RESTRUCTURING, AND THE CHINESE EDUCATION SYSTEM

REF: A) 09 CHENGDU 271, B) 09 CHENGDU 310, C) 09 BEIJING 665

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¶1. (U) This cable contains sensitive but unclassified
information - not for distribution on the Internet.

¶2. (SBU) Summary: The head of the World Bank's International Finance Corporation (IFC) office in Chengdu, a PRC national with a patriotic bent, acknowledged that China faces possible asset bubbles, but was confident that China's "strong and technocratic" government would intervene effectively if the signals of overheating became too severe. Rapidly rising urban housing prices are here to stay for the coming few years, he believes, as they are an unavoidable, long-term aspect of the nationwide, structural shift in the population from rural area to urban centers. The IFC is trying to push Beijing to address the lack of affordable housing for moderate income households. China does have overcapacity in several industries, but the emphasis on mega-projects by local politicians, many of whom are engineers, will make reducing overcapacity more difficult. Over the next 10-20 years, China will need to restructure its economy so that it has a significantly higher share of knowledge-based services, especially research and development. However China's "terrible" educational system, which promotes copying and pasting over creative and independent thought, is the largest impediment the country faces on this front, our IFC contact said. End summary.

Asset Bubbles: "Signs Are There",

But Government Intervention Will Address

¶3. (SBU) In a December 17 meeting with Consul General, the head of IFC's Chengdu office, Lai Jinchang, discussed the question of whether stimulus policies have created asset bubbles in the Chinese economy. Lai noted the "staggering" amount of credit the government injected into the economy in 2009, contrasting the estimates of around 9.3 - 9.4 trillion RMB (USD 1.3 - 1.4 trillion) with the "normal" annual figure of less than 4 trillion (USD 588 billion). This has certainly caused inflationary pressures - he particularly noted increased prices in iron and steel, petroleum products, electricity, water, edible oil, and produce. However, Lai, perhaps in part out of

patriotism and bureaucratic survival instincts, made the ambivalent prognosis that, although "The signs of an asset bubble are there," the economy was not yet experiencing "genuine" asset bubbles.

14. (SBU) Overall, Lai said he was not worried about the possible emergence of asset bubbles because of the Chinese government's capacity to track the situation and take timely and effective action. If credit needs to be further reigned, the government will just set a new quota and make it happen. In particular, he highlighted the December Communist Party of China (CPC) Economic Work Conference, where participants emphasized the need for some cooling down of credit. He also noted the Central Bank of China's public stance on moderating credit in the coming year. Lai assessed the basic economic policy stance going into 2010 as unchanged, continuing to emphasize a favorable monetary policy, but with the size of the credit expansion significantly reduced.

Overcapacity in Number of Industries:

Local Politicians Contribute to the Problem

15. (SBU) Asked about the European Chamber of Commerce in China's recent report on overcapacity in China, Lai said he had not yet read the report, but agreed that overcapacity was a problem in a number of industries. He highlighted the bio-energy, wind and solar industries in particular, noting that they had grown rapidly in recent years as a result of a surfeit of subsidies, and would likely face a period of restructuring. He also

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expected the industries targeted in the central government's ten-industry stimulus plans (Ref C) to develop overcapacity.

16. (SBU) Regardless of concerns about national overcapacity, local politicians, such as in inland provinces of Southwest China, will continue to rely on investment in large projects to boost local GDP and further their own prestige, Lai said. He agreed that Leshan in Sichuan, where the city is planning three billion USD investment in transportation and industrial infrastructure (see Ref B) may be such a case. "They are mostly engineers so they understand mega-projects, but they don't understand the law," Lai stressed, further explaining that he views most Chinese leaders as lacking an understanding of institution building. However, he said, the emphasis on large projects to boost GDP figures is "not all bad." After all, "they have been doing it for decades" and there have clearly been some benefits.

Inflated Housing Costs: Here to Stay as Urbanization Continues; Moderate Income Households Most Severely Affected

17. (SBU) While housing prices have certainly seen some increase, this is not a major issue in cities such as Chengdu, Lai felt, as prices generally remain within reason. Discussing the Beijing and Shanghai markets, he described the housing prices as "a little scary" and in many cases "totally out of reach" for the vast majority of Chinese citizens. Nevertheless, investment in the hotter housing markets - for those who can afford it -- will likely remain secure for a while to come, he predicted.

Although purchase prices often far outstrip realistic rental incomes, the capital gains on most housing purchases will continue to make the purchases worthwhile. The apparent excess of new empty apartment buildings in urban areas, along with price increases, was not necessarily irrational, Lai asserted. Rather, he believed these trends to be driven by the long-term process of urbanizing the Chinese population - a process that still has years to go. Separately, Lai asserted that one problem with including housing prices in China's Consumer Price Index (CPI) is that the commercial housing market was immature and just over a decade old (so that the data was not yet reliable enough for its inclusion in the CPI).

¶8. (SBU) Overall, he said, the current housing market in China is still manageable for middle and high income households. Low income households are also managing as they have access to government housing programs whereby they can rent low-cost homes. However, moderate income households - with incomes too high to qualify for low-income housing but falling short of the middle class -- are falling through the cracks. The IFC is trying to push the government to address this problem, with a focus primarily on incentivizing commercial developers to build moderately priced housing for this market. To this end, Lai believes the government should conditionally support developers by providing lower priced land and government subsidies. In addition, he emphasized the need for mortgage insurance, and more broadly for capital market development in order to broaden mortgage access.

Toward a "Respectable" Mid-Level Economy in 10-20 Years: China Must Shift to Become a Knowledge - and Service-Based Economy

¶9. (SBU) China will remain a "poor country" for years to come, and can expect to emerge as a "respectable mid-level" country only in another 10-20 years, Lai said. Successful development over this period will require a structural shift so that Chinese companies' share of the intangible elements of economic output increase significantly. China's share of the research and development, services, and marketing remains low, he emphasized. He stressed that the service sector accounts for only 30-40 percent of the economy at present, in contrast to the US at 75 percent, and Europe at 70 percent. In the coming years, China

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needs to affect a shift to increase the service sector to at least 60 percent.

¶10. (SBU) The necessary structural shifts are already happening to some extent in places like the Pearl River Delta, Lai noted, highlighting a transition there from industries requiring low-tech labor, to those that are increasingly skills-based. Citing historical shifts in other Asian economies such as South Korea, he also foresaw Chinese companies increasingly setting up factories overseas, utilizing local labor with Chinese management. As the Chinese economy shifted to become more knowledge-based, and as Chinese companies increased their overseas presence, the constituency for IPR protection would also expand, he believed.

"Terrible" Education System Is Main Impediment

¶11. (SBU) However, Lai identified China's "terrible" educational system as presenting a serious impediment toward achieving a shift to a more knowledge-based economy. The current system promotes copying and pasting over creative and independent thought. Lai said that the system rewards students for thinking "within a framework" in order to get the grade. He described the normal process undertaken by students when writing as essentially collecting sentences from various sources without any original thinking. He compared the writing ability of a typical Chinese Phd as paling in comparison to his "unskilled" staff during his decade of work with the IFC in Africa.

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